FORBES

Fed Chairman Powell, Does A ‘Hotter Than Hades’ Blip Portend Onrushing Inflation?

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Monetary policy is crucial to the markets and to the economy. While typically somewhere between invisible and occult, dollar policy is why the choice of the successor to Gary Cohn matters to America's economic, and President Trump's political, fortunes and is why President Trump should pick a director of the National Economic Council who has a strong grasp of this.

The Big Question right now: Is misery-inducing inflation sneaking back, forcing the Fed to tighten?

JP Morgan recently downgraded its first quarter growth estimate to 2.5% in part based on an inflation report that its chief US economist picturesquely characterized inflation as “hotter than hades,” As reported by Yahoo Finance:

> J.P. Morgan slashed expectations for U.S. economic growth in the first quarter thanks to Wednesday's "hotter than Hades" inflation reading and "ugly" retail sales numbers.
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> The bank's chief U.S. economist explained that the Labor Department's "scorching" core consumer price index measure likely means an emboldened Federal Reserve.
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> "While it is still early going, we are taking down our outlook for first-quarter gross domestic product from 3.0 percent to 2.5 percent," wrote economist Michael Feroli. "Today's inflation reading should probably cement in place the Fed's intent to hike rates at the March FOMC meeting."
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> The economist added that core CPI posted a 0.349 percent monthly gain, its largest month-over-month gain since 2005. Though economists across Wall Street have differed on how many times the central bank is likely to raise rates in 2018, the odds of a March rate hike are now over 80 percent, according to the CME FedWatch tool.
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> The Atlanta Fed also lowered its projection on Wednesday, calling for growth of 3.2 percent in the first quarter versus prior expectations of 4 percent on Feb. 9.

What's up? One swallow doth not a summer make and, to continue the ornithological metaphor, one CPI blip is not a canary passing out in the coal mine. That said, inflation really would be destructive. So, however, would an overreaction precipitating a deflationary recession, maybe just in time for the 2020 election.

Much to the confusion and consternation of then-reigning presidents Nixon, Ford, and Carter, virulent inflation then prevailed. If ignorance is bliss, President Jimmy Carter must have been blissful indeed. He said in a 1978 address to the nation:

> Inflation is obviously a serious problem. What is the solution?
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> I do not have all the answers. Nobody does. Perhaps there is no complete and adequate answer. But I want to let you know that fighting inflation will be a central preoccupation of mine during the months ahead, and I want to arouse the nation to join me in this effort.
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> …
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> I've spent many hours in the last few months reviewing with my own advisers and with a number of outside experts every proposal, every suggestion, every possibility in eliminating inflation. If there's one thing I have learned beyond any doubt, it is that there is no single solution for inflation.
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> What we have, instead, is a number of partial remedies. Some of them will help; others may not. But we have no choice but to use the best approaches we have and to maintain a constant search for additional steps which may be effective.

Wrong from start to finish. Wrong as well were his pastiche of "remedies" – federal spending restraint, tax incentives, regulatory rollbacks, and so forth. Milton Friedman had stated the complete and adequate answer over a decade before, in *Inflation Causes and Consequences*, (1963): "Inflation is always and everywhere a monetary phenomenon." And notwithstanding Friedman's late life distancing from monetarism, no serious thinker now repudiates this observation, one that is as fundamentally true as the law of gravity.

Meanwhile, the Labor Department's most recent jobs report was so unexpectedly great it muted the economic naysayers, however briefly. As reported by Yahoo Finance:

> The US economy added 313,000 jobs in February, many more than economists had expected, according to a report from the Bureau of Labor statistics released Friday. Wage growth slowed.
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> The labor-force participation rate increased by the most in over eight years, to 63%, confirming that many more working-age Americans are still out of a job. The unemployment rate was unchanged at 4.1%, the lowest since December 2000, yet a broader measure that includes people who work part time but want full-time jobs was higher, at 8.2%.
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> Most of the job gains last month were in the construction and retail sectors.
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> Economists had estimated that the economy gained 205,000 nonfarm payrolls in February and that the unemployment rate fell to 4%, which would have been its lowest since July 2000, according to Bloomberg.

> The focus of this report was wage growth. Average hourly earnings increased by 0.1% month-on-month and 2.6% year-on-year.

A blip up in the CPI and soaring job creation? The spurious Phillips Curve holds that too much job creation drives up wages which trickles down to create inflation. Despite having been thoroughly discredited the Curve lives on as a specter intermittently haunting the Federal Reserve. Giving it credence could trigger unwarranted tightening.

Let's drive a stake through the Curve's heart. The Phillips Curve, of course, is not just wrong but wrong-headed. As Steve Forbes wrote here last December 12:

> **--Belief in the superstition of the Phillips Curve.** The Fed clings to the idea that prosperity causes inflation and that inducing unemployment--that is, trying to make millions of people lose their jobs--cures it. And then there's the decade-old mantra of needing to raise the inflation level to get the economy out of its post 2008–09 torpor. Real-world experience has demonstrated the preposterousness of that idea.

Inflation is always and everywhere a sign that the monetary authorities are injecting more liquidity into the money markets than those markets demand, causing, after a fairly predictable lag, rising price levels. Deflation, of course, is the reverse.

Higher real wages – a Very Good Thing – will not contribute to a rising consumer price level. Inflation comes from the Fed hitting the gas pedal too hard. Should the White House be worried that the CPI core inflation rate blipped up? Should that induce the Fed to tighten?

Tightening, let us note, is done on the balance sheet, not by raising the discount rate. Raising the discount rate is a shibboleth, as demonstrated by Heritage Foundation's Norbert Michel channeling Prof. Diedre McCloskey:

> Diedre McCloskey, for instance, pointed out in 2000 that the Fed's open market operations constitute a very small part of the world's capital markets. McCloskey highlighted that, in a capital market of approximately $300 trillion, the Greenspan Fed typically increased or decreased its bond holdings in the neighborhood of $40 billion per year.

So, what's really going on? There's considerable uncertainty, especially with the assumption of the chairmanship of the Fed by "Cautious Hawk" Jerome Powell. One also must very much keep in mind the wishes of the President. The president has the power to sink the dollar.

Many have done so. Misery always ensued.

The nominal autonomy of the Fed is a fiction. Per Steven Solomon in his *The Confidence Game: How Unelected Central Bankers Are Governing the Changed World Economy* (Simon & Schuster, 1995, pp. 153-4):

> Although they strained to portray themselves as nonthreatening, nonpartisan technician-managers of the status quo, central bankers, like proverbial Supreme Court justices reading election returns, used their acute political antennae to intuit how far they could

> lean against the popular democratic winds. "Chairmen of the Federal Reserve," observes ex-Citibank Chairman Walter Wriston, 'have traditionally been the best politicians in Washington. The Fed serves a wonderful function. They get beat up on by the Congress and the administration. Everyone knows the game and everyone plays it. But no one wants their responsibility.'
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> Democratic leaders tolerated central bankers' special unspoken role because they welcomed the depoliticization of money questions. Why? … For most politicians it was easier to leave the thankless, necessary decisions to the technocrats at the central bank--and then join in the popular outrage against them.

There are unsettlingly persistent rumors that President Trump wants to substantially cheapen the dollar. And as *Forbes.com*'s own John Tamny relentlessly calls out: "Presidents generally get the dollar they want."

As the *FT* reported on February 21:

> Here's a conundrum: the dollar index has dropped 2.5 per cent so far this year, and no one seems to agree about why the US currency has been soft in 2018.
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> It's not that there aren't reasons. Rather conversations with analysts, strategists and investors have thrown up so many wide-ranging and contradictory explanations, we thought it would be useful to simply present the full list, without passing judgement.

The FT's possible explanation, item 17 out of 17:

> Donald Trump. The US is no longer seen as reliable on the international stage and a historically unpopular president is viewed as a military liability and a soft-dollar president.

So, might we be on the verge of a sinking dollar and relatively virulent inflation … perhaps to be followed by Chairman Powell's silver hammer?

Maybe not.

Last year, Alan Greenspan finally fessed up to using the gold price as the signal to determine whether to tighten or loosen during his halcyon period of low inflation high job creation. As I wrote here:

> Former Fed Chairman Alan Greenspan just provided a barely noticed Big Reveal. In an interview with the World Gold Council's *Gold Investor* Chairman Greenspan, stating "I view gold as the primary global currency," went on to explicitly reveal, for the first time to my knowledge, that "When I was Chair of the Federal Reserve I used to testify before US Congressman Ron Paul, who was a very strong advocate of gold. We had some interesting discussions. *I told him that US monetary policy tried to follow signals that a gold standard would have created.* [Emphasis supplied.]
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> The period of "following signals that a gold standard would have created," called the Great Moderation under President Clinton, was one of the most equitably prosperous in

> modern American history. That era saw the creation of over 20 million jobs. Robust growth converted the federal deficit into a surplus. It was, if only virtually rather than institutionally, a golden age.

Chairman Greenspan's emulation of the gold standard during the Great Moderation was long a subject of speculation, most impressively in 1995 in *Gold Price Targeting By The Fed* by monetary economists William Lastrapes and George Selgin (now at Cato Institute) from the University of Georgia.

Demonetized gold, which actually means the degoldenized money delivered by Presidents Johnson and Nixon, behaves somewhat differently from gold that is convertible to the dollar. That said, consider the macroeconomic success of Greenspan during the Great Moderation by simply emulating the gold standard. If it as yet is deemed too painfully déclassé to restore the classical gold standard, let's just demurely call the expedient of targeting the gold price "Greenspanification of the Greenback" and pray that Chairman Powell adheres to it as a step in the right direction.

Consider the stabilization of the price of gold to between $1100 - $1400 over the past five years, primarily between $1200 - $1350. Spot gold most recently closed, as of this writing, at $1323.49. And consider the continuous, if woefully subdued, economic recovery.

Is this gold price the result of an intentional targeting by the Fed? That's the $64,000 question, of course. Given the duration, although not rate, of the recovery under Obama and its apparent intensification under Trump, one can legitimately wonder whether the Fed has put the price of gold onto its instrumentation panel.

Both by following it and thus stewarding the Great Moderation and by abandoning it and thus putting us on the rough road of booms and busts Chairman Greenspan proved that there are real macroeconomic benefits to relying on price signals from the commodity least affected by business-cycle fluctuations in demand (due to gold's trivial industrial uses).

There are excellent reasons to be far more skeptical toward the Dynamic Stochastic Equilibrium Modeling upon which the Fed's phalanx of PhD economists rely than upon the simple gold price. The gold price historically proved extremely effective at signaling the monetary authorities as to when to inject or withdraw liquidity. It worked for hundreds of years better than anything tried before or since.

Consider Prof. Robert Mundell's 1999 Nobel Prize lecture *A Reconsideration of the Twentieth Century* -- mostly a review of the gold standard and the effect of deviating therefrom. Mundell observed:

> The twentieth century began with a highly efficient international monetary system that was destroyed in World War I, and its bungled recreation in the interwar period brought on the Great Depression, Hitler, and World War II. The new arrangements that succeeded it depended more on the dollar policies of the Federal Reserve System than on the discipline of gold itself. When the link to gold was finally severed, the Federal Reserve System was implicated in the greatest inflation the United States has yet known, at least

> since the days of the Revolutionary War. Even so, as the century ends, a relearning process has created an entirely new framework for capturing some of the advantages of the system with which the century began.

Chairman Powell implies he will continue to gingerly, incrementally, withdraw liquidity on a schedule already discounted by the markets.

Employment up? An unsettling CPI blip? Does that bring the Phillips Curve, which would expect, even welcome, that correlation, back from the dead? Pray not!

Meanwhile, the free market price of gold suggests that virulent inflation isn't on, or even over, the horizon.

In the final days of Janet Yellen's tenure as Fed chair the price of gold rose from 1240 to around the mid-1300s, , possibly a signal that she recognized the Fed had been excessively tight. That price has mostly remained in the mid-1300s under Chairman Powell. Too soon to tell yet if the Fed is in search of a stable "Goldilocks" gold price, not to hot, not too cold, just right. If so, that bodes well for the economy, the financial markets, and the Republicans.

Too loose: inflation. Too tight: recession. The 2018 midterm elections and President Trump's prospects for re-election in 2020 both likely depend on the vibrancy of the economy: high real growth in a noninflationary environment.

That, in turn, depends above all on good monetary policy to deliver low inflation with full employment and rising median wages. The value of your investment portfolio also depends, above all, on good monetary policy.

No pressure, Chairman Powell. No pressure, President Trump.

The eyes of the world are upon you.